WOODLOT MANAGEMENT
HOME STUDY COURSE

MODULE 10: Part B

MANAGING WOODLOT FINANCES:
Income Tax and Estate Planning Guide

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PREFACE

Income tax and estate planning are important considerations for most woodlot owners. In the following pages we discuss these complicated subjects in a way that can be understood by those who are not in the financial planning field. Technical terms are explained in a glossary at the back of the booklet. These terms appear *in italics* throughout the text.

This module was originally written for New Brunswick woodlot owners in 1997 by Bruce Lunergan, a chartered accountant based in Fredericton. It has been updated and modified for Nova Scotia landowners by Susan McIsaac, a chartered accountant based in Amherst, Nova Scotia.

This module is a complement to module 10A, a planning and investment guide that helps owners develop a personal business plan based on the financial benefits of buying, improving, and protecting woodland.

This module is number twelve in a series of woodlot management home study courses. Other modules in the series include:
1A. Getting More From Your Woodlot: An Introduction to Integrated Resource Management
1. Introduction to Silviculture
2. Harvesting Systems
3. Stand Spacing
4. Wildlife and Forestry
5. Stand Establishment
6. Chain Saw Use and Safety
7. Woodlot Ecology
8. Wood Utilization and Technology
9. Woodlot Recreation
10A. Managing Woodlot Finances: Planning and Investment Guide

These modules are available from the Nova Scotia Department of Natural Resources, Extension Services Division, P.O. Box 698, Halifax, Nova Scotia. B3J 2T9. Fax 902-424-7735. Modules can also be ordered by phone at 424-6295 or 424-5444 and by Email maccorma@gov.ns.ca or twwhynot@gov.ns.ca. Some of the modules can also be viewed and downloaded from our website at: http://www.gov.ns.ca/natr/regional/extension.

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PART 1: INCOME TAX GUIDE

LESSON 1: INTRODUCTION TO WOODLOT TAX PLANNING

The purpose of part one of this guide is to outline and discuss the main income tax rules and business issues that apply to woodlot operations in Nova Scotia. It is not meant to be a complete guide to taxes—we will not deal with GST, HST, or property taxes here.

In this guide, we use the word "woodlot" in a broad sense to mean land covered with trees. A woodlot includes treed land held primarily as a source of fuel, posts, logs, or trees—whether the trees are grown with or without human intervention. The term also includes treed land that is part of a cottage property or a farmer's wooded land.

Income tax rules and tax planning opportunities that apply to woodlots are complex. In this guide we will discuss issues in a general way only. We will not attempt to investigate all the traps and pitfalls of legislation that is becoming more and more technical. To apply the information in this module to a particular situation, we recommend that you seek assistance from a professional accountant.

BUSINESS INCOME AND CAPITAL GAINS

Is your woodlot commercial or non-commercial?

Where a taxpayer operates a woodlot as a business with a reasonable expectation of profit, it is called a *commercial* woodlot. A woodlot that is not operated by a taxpayer as a commercial woodlot is known as a *non-commercial* woodlot.

We can only determine whether or not a woodlot owner reasonably expects to profit from the woodlot by looking at the facts. You should ask yourself the following questions:

- Do I have a forestry management plan? Is it comprehensive? Am I implementing it?
- How much time do I spend on the woodlot operation compared to time spent on other income earning activities?
- How big is the woodlot? (It may be too small to give a reasonable expectation of profit).
- Do I qualify for some type of government assistance?
- What annual revenue, profits, or losses has the woodlot made in the past?
- What expenditures do I claim and are they relevant to operating the woodlot?
- What are my farming or forestry qualifications (education and experience)?
- Do I belong to an association of woodlot owners or other relevant professional business organization?

No single factor will determine if your woodlot has a reasonable expectation of profit. Some factors may be more important than others, depending on the circumstances.

Whether a woodlot is commercial or non-commercial is extremely important, as the following distinction between *capital gains* and business income will make clear.

Business Income

Income from a business has always been taxed differently from *capital gains*. Business income is fully included in income, but *capital gains* income is given preferential tax treatment. If the woodlot owner has a commercial woodlot (for example, actively cuts and sells the wood product), it seems clear that he or she is in business, and revenues received are included in computing business profits.

Capital Gains

On a *non-commercial woodlot,* where harvesting wood is not part of the taxpayer's principal business activities, and money or other valuable consideration is received for the sale of timber or the right to cut timber, the sale proceeds are subject to tax on capital account. Generally they are taxed as a *disposition* of "personal use property." A loss on the sale of personal use property is not usually deductible. Where the proceeds from a sale of timber are more than $1,000, the sale may result in a *capital gain*[1].

The portion of the *capital gain* that is taxable depends on the date that the sale is made:

- only half (50 percent) of the *capital gain* is included in taxable income if the sale was made after October 17, 2000
- two-thirds (66.67 percent) of the *capital gain* is included in taxable income if the gain was acquired after February 27, 2000 and before October 18, 2000
- three-quarters (75 percent) of the *capital gain* is included in taxable income if the gain was acquired before February 28, 2000

The *capital gain* is calculated by deducting the *adjusted cost base* of the woodlot from the proceeds of sale, less any costs of *disposition*. If only a portion of the woodlot is cut, the *adjusted cost base* relating to the sale is calculated as a percentage of woodlot cut over the total woodlot (less the residual value of the land), multiplied by the total cost.

You should note that if a taxpayer has merely owned a woodlot without being in business, gearing up to harvest the wood himself may result in a deemed (assumed) sale and repurchase of the property at *fair market value*. We will discuss this in more detail later under the heading "change-of-use."

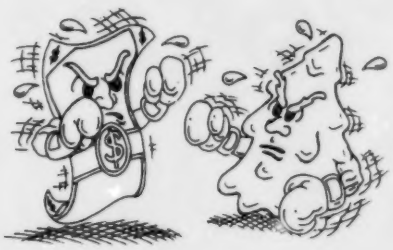
The rest of Part One of the guide will be devoted mainly to those taxpayers who own and operate a woodlot as part of their ongoing business activities.

Business Losses
When computing your business income, you are only allowed to deduct expenses that were incurred for the purpose of gaining or producing income from the business[2]. This provision of the Income Tax Act operates nicely when profits are being earned, but leads to uncertainty when losses are being made. For a woodlot operation to have a "reasonable expectation of profit," a taxpayer should be able to show that, with experience, skills, plans and financing, the operation will be profitable over the long run. It is not enough to purchase or own a property and hope that it will yield a profit.

If losses continue for several years, it becomes more and more important that you can demonstrate a "reasonable expectation of profit" (supported by financial projections and other evidence), as the Canada Customs and Revenue Agency are more likely to challenge you with each year that passes. If you cannot demonstrate a "reasonable expectation of profit," the expenses/losses (net of revenues) are considered to be personal in nature.

Adventure in the nature of trade
A sale of timber that is an "adventure in the nature of trade" is considered to be business income. The main consideration in determining whether a sale of timber is an "adventure in the nature of trade" is whether the taxpayer's actions were essentially what would be expected of a dealer in the same property.

Payments based on production or use
Where a woodlot owner allows a person to cut and take timber and payment is based on the volume of timber taken, the payment is taxable as business or property income (see paragraph 12(1)(g) of the Income tax Act). The courts have limited the application of this paragraph to the one-time removal of all of the timber from agricultural property with a fixed price per cord or ton. They may extend this to non-agricultural property in the future.



Income can either be claimed as business income or as a capital gain.

Also, where a contract calls for a fixed price that cannot be varied in any event, but the timing of instalments of that fixed price is to vary depending on production or use, then a *capital gain* will result, and paragraph 12(1)(g) will not apply. In other words, if the cut is a one-time deal (cleared for agricultural use) the payments are capital instead of income even though they were based on production—that is, volume.

On the other hand, if a contract fixes

the price for the entire cut on a per hectare basis (instead of volume), then the payment can be considered capital even though payments may be made periodically during cutting. This is rather a grey area, so get advice if you are in this situation.

Exercise 1. A landowner hires a contractor to harvest from his/her woodlot every second year. The contractor pays the owner based on how much volume he harvests. Should this payment be claimed as income or a capital gain?

LESSON ONE QUIZ

Based on your study of this lesson, please choose the best answer.

1. The manner in which a taxpayer operates a woodlot may determine the amount of income tax owing. T F

2. Where a woodlot owner can clearly show that he expects to profit from operations on the woodlot, the woodlot is referred to as a commercial woodlot. T F

3. A woodlot that is referred to as a non-commercial woodlot will have income treated as business income. T F

4. Where there is no attempt to operate a woodlot as a business, income received from timber sales on this woodlot is treated as Capital Gains. T F

5. When calculating taxable income from a Capital Gain realized in 2000, the Capital Gains rate of 75% is used. T F

6. As long as the woodlot is referred to as a commercial woodlot losses may be realized year after year forever. T F

7. Income received from sales of timber classified as an "adventure in the nature of trade" is reported as a Capital Gain. T F

8. The actual terms of a stumpage contract which specify how and when payments are to be made can determine whether the income will be treated as Capital Gains or business income. T F

9. What percentage of the capital gain must be included in taxable income if a woodlot was sold on October 20 2000?
   A) 50% B) 100% C) 66.66% D) 75%

(Answers on page 67)

LESSON 2: BUSINESS TYPES

BUSINESS ENTITIES

The three most common types of business (sometimes called business entities) are proprietorships, partnerships, and corporations. Each of these has unique legal and income tax features.

Proprietorship

A proprietorship is a business carried on by an individual. The individual is the owner, in charge of and ultimately responsible for all activities of the business. The owner assumes all the risks and does not share the profits or losses. Profits are calculated after deducting reasonable wages to others involved in the business. There is no legal difference between the individual and the proprietorship. If the business fails, the individual's personal assets may be subject to seizure.

For income tax purposes, the business income and losses are added to the individual's income from other sources. Tax is then calculated on total income at graduated personal income tax rates. Lumping income and losses from different sources together allows the individual to deduct losses against other forms of income, such as employment or investment. This may be a big advantage during a business start-up period, when there are often losses.

If business losses exceed income from other sources in a particular year, the excess may be carried back three years and forward seven and used as deductions in those years. If the losses are from farming, they may be carried back three years and forward ten. But if the losses are "restricted farm losses" (we will discuss these later), they can only be deducted from farming income in those carryover years.

You should note that the word loss or losses refers to the situation where deductible expenses exceed revenues. It does not necessarily include the situation where a woodlot owner suffers an economic loss due to a natural event such as fire, hurricane, or insect damage. Under these circumstances, the taxpayer might be entitled to a write-off only if there are previously undeducted costs associated with the woodlot. Such a write-off would not be available for any costs attributed to the underlying land.

When the owner sells or otherwise disposes of the business assets - for example, by transfer to a family member, deemed *disposition* on change-of-use from business to personal use, or deemed *disposition* on death - business income or losses may be acquired as well as *capital gains* or *losses*.

Partnership

A partnership is an agreement between two or more parties to combine resources, credit, and expertise to carry on business together in order to earn a profit. Although the partnership possesses assets and property of its own, it is not a separate legal entity from the partners. Each partner is fully responsible for the debts and business obligations of the partnership. If the business fails, each partner's personal assets may be subject to seizure. Although a written contract is not necessary, a signed partnership agreement is highly recommended. This agreement should set out the rights and obligations of the individual partners including:

- income sharing entitlements
- financing or capital requirements
- property to be contributed
- personal involvement requirements
- expulsion
- termination of agreement

A partner who contributes a particular asset to a partnership would not necessarily receive the asset back if the partnership is dissolved unless it is written into the partnership agreement or otherwise agreed to by the partners.

For income tax purposes, the partnership calculates its taxable income and allocates this amount among the partners. A partnership does not file its own income tax returns. Each partner includes his share of income or loss on his personal income tax return. The result is the same as if each partner were a proprietor who had earned that much income or suffered that much loss. The loss carryforward and carryback rules are the same as for a proprietorship.

An interest in a partnership is a *capital property* that can be sold or transferred to another person. Any gain or loss would be a *capital gain* or loss. The cost of a partnership interest is increased by the partner's share of earnings and reduced by the partner's share of withdrawals or distributions from the partnership.

On wind-up, a partnership generally disposes of all of its assets to its partners at *fair market value*. Business income and *capital gains* acquired would be allocated to the partners. However, a *rollover* is available on the wind-up of a partnership where each partner receives a pro-rata undivided interest in each property of the partnership. The benefit of this *rollover* provision is that inherent gains in the partnership property are not taxed until some time in the future. The drawback is that the partners must hold the property (distributed on wind-up) jointly. If this is impractical for some assets, they may be distributed to particular partners before the wind-up. A similar type of *rollover* is available where one partner buys out the other partners and carries on the business as a proprietorship.

Corporation

A corporation is a separate legal entity, distinct from its shareholders. It may own assets and incur debts and can generally contract and negotiate on its own behalf. Shareholders are not responsible for the debts of the company unless they have provided personal guarantees. Private companies are usually set up under the laws of a province, although federal incorporation is also available. The incorporating statute will impose some formalities on the company, such as the need to hold meetings, elect directors and officers, and so on.

For tax purposes, a corporation calculates its own taxable income and files its own tax return. You can see from Table 1 that a company pays tax at a favourable rate on its first $200,000 of business income earned in a particular *fiscal year*. If the business is profitable and generates more income than the shareholders need for their personal living requirements, this difference in tax rates is a big advantage to incorporation. The tax savings provide additional funds to finance growth or reduce debt. However, this difference in taxes is actually a deferral of tax. There is a second level of taxation when the retained earnings of the company are eventually distributed to the shareholders. Nevertheless, this tax bill may be postponed indefinitely.

The shares of certain qualifying corporations are eligible for a $500,000 *capital gains* deduction on their *disposition*. There are tests to be met, but as long as substantially all of the company's assets are used in the business the shares should qualify. Other assets, such as excess cash, stock market investments, or rental properties, may create problems which may be avoided with advance planning and preparation, but the shares of many private companies will qualify. On the other hand, if the business is carried on as a proprietorship or partnership, only *capital gains* on qualifying farmland, farm buildings, farm quota, and interests in family farm partnerships are eligible for the $500,000 *capital gains* deduction. So if the business is not farming, the $500,000 *capital gains* deduction can only be achieved if it is carried on through a corporation.

One disadvantage of incorporation is that, if there are losses in the early years of a business, there is often no other source of income in the company against which they can be claimed. Otherwise, the loss carryover rules for corporations work exactly the same as for proprietorships and partnerships.

On a wind-up of the business and distribution of the assets to the individual shareholders, the company is taxed based on the *disposition* of assets at market value. Shareholders will also be taxed on the amount of taxable dividends they are considered to receive. This ends the tax-deferral advantage of incorporation we mentioned earlier, which is why

corporations often carry on as personal holding or investment companies after the business activities have been wound down.

In a proprietorship, one person is in charge and responsible for the business activities. In a partnership, two or more parties are responsible for the business activities. In a corporation, shareholders are not responsible for the company debts.

Choosing the right business entity

Choosing the right business entity will always depend on the particular circumstances of the business. Limited legal liability and lower income tax rates available through a corporation are often deciding factors, but these are offset somewhat by higher cost of administration and complexity. Other factors, such as the impact of tax on the wind-up, dissolution, or sale of the business, are usually far enough in the future that they can be ignored.

The table on page 11 highlights the difference between personal and corporate income tax rates on business income, and compares the tax and non-tax factors that should help you choose a business entity. A score of one shows that the advantage lies with that choice of entity. A score of three shows a disadvantage for that entity. If there is no significant difference between two or more entities, their scores have been averaged. We have tried to rank the factors in decreasing order of importance. However, the scores and the rank are subjective judgements, meant to serve as a guideline only.

Switching

You can generally start a business operation as a proprietorship and transfer the business assets to a partnership or a corporation at a later

time without immediate tax consequences. Usually, you can also incorporate a partnership without tax consequences or, as we mentioned before, one partner can usually acquire the other partners' interests in the partnership and carry on the business as a proprietor without tax consequence to the continuing partner.

But there are no provisions in the Income Tax Act for the transfer of business assets in a company out to individual shareholders so that the business can be carried on as a proprietorship or partnership. Such a transfer can rarely be made without tax cost. Transfers of business assets between companies can often be achieved without income tax effect.

Although switching between business entities is often feasible, it is certainly a complex area from an income tax point of view. There are many technical traps to avoid and many planning opportunities that should be considered, such as estate planning, income splitting, creditor protection, and so on. As a result, the current cost of completing a switch is often seen as a deterrent. Remember that the purpose of "switching" is to achieve long-term advantages. Up-front costs should be evaluated just like any investment undertaken by the business. Professional assistance is a must.

NATURE OF THE BUSINESS

If we are carrying on business activities with a "reasonable expectation of profit," we must determine the nature of the business before we can find out if any special income tax provisions are available. Several unique provisions apply to farmers and a few apply to loggers.

Farmers and Tree Farmers

The Income Tax Act defines farming as: "farming includes tillage of the soil, livestock raising or exhibiting, maintaining of horses for racing, raising of poultry, fur farming, dairy farming, fruit growing and the keeping of bees, but does not include an office or employment under a person engaged in the business of farming.[3]" Note that this list is not exhaustive, and the courts have determined that farming can include growing trees.

Canada Customs and Revenue Agency (CCRA) takes this view: if the main focus of the woodlot business is not lumbering or logging, but is planting, nurturing, and harvesting trees under a forestry management or other similar resource plan, and significant attention is paid to managing the growth, health, quality, and composition of the stands, it is generally considered a farming business (a commercial farm woodlot).

Ranking of business entities based on tax and non tax factors. (Actual Nova Scotia Marginal 2001 tax rates are found in appendix 1.) A lower score implies an advantage lies with that business entity for that particular tax or non-tax factor. A higher score implies a relative disadvantage. If there is no significant difference, scores have been averaged.

Non Tax Factors	Proprietorship	Partnership	Corporation
Legal liability/risk	2	3	1
Availability of skills	3	2	1
Availability of financing	3	2	1
Simplicity	1	3	2
Administrative costs	1	2.5	2.5
Ease of entry/exit	1	2.5	2.5

Tax Factors	Proprietorship	Partnership	Corporation
Income tax rates	2.5	2.5	1
Deductibility of losses against other forms of income	1.5	1.5	3
Loss carryovers	2	2	2
Capital gains deduction	2.5	2.5	1
Disposal of business	3	2	1
Wind-up of business	1.5	1.5	3

If the main focus of a business is logging (a commercial non-farm woodlot)—not growing, nurturing, and harvesting trees—carrying out reforestation activities would not transform that business into a farming operation.

A woodlot owner who grows and nurtures evergreens to sell as Christmas trees is regarded as being in the farming business regardless of whether he or she is carrying on any other type of farming operation—provided the operations are carried on with a reasonable expectation of profit.(4)

Where a "traditional" farmer is also a woodlot owner, the CCRA considers income from the woodlot to be income from farming.

Generally, a taxpayer who is not otherwise engaged in a lumbering or logging business, and who reforests an area of land to produce mature trees at a date that may be 40 or 50 years in the future (or even longer), is considered to be farming.

Exercise 2. Susan Black has a management plan for her 132 acre woodlot. Since she does not live near her woodlot she hires a contractor to manage it for her. The contractor looks after all the operations including harvesting, planting, thinning, and so on. Does Susan's woodlot business qualify as a commercial farm woodlot?

_____

_____

(see page 67 for answer)

So, a woodlot owner who has reforested land and a woodlot owner who operates a woodlot alongside traditional farming activities, are both considered to be carrying on farming operations. In practice, it is easier for a corporate taxpayer to carry on a reforestation, cultivating, and harvesting operation as a farming business. The indefinite life of a corporation lends itself to the long business cycle of a tree farming operation.

Contractors and Loggers

There is another class of woodlot owners—those who purchase cutting rights or forested land for the purpose of harvesting and marketing the wood product. CCRA considers these taxpayers to be carrying on a logging business rather than farming. While this appears generally to be the case if

purchases are of mature forests only, it does seem debatable where immature woodland is being cultivated to maturity. Where a taxpayer relies on naturally seeded regeneration, whether or not the business is a farming business depends upon the focus of the business and how the trees are nurtured.

Special Farm Rules

We noted above that several special income tax provisions benefit farming. Some of these are:

1. Cash Basis Accounting. Business income is normally measured using the *accrual basis* of accounting. Under the accrual method, you include accounts receivable in revenues and add accounts payable to expenses. You remove the cost of *inventory* on hand at the end of a *fiscal year* from expenses and report it as an asset.

If you use the *cash basis*, you only use revenues actually received and expenses actually paid in the year to determine income. The cost of *inventory* on hand at the end of the year is generally included in expense. As well as keeping things simple, this method accelerates the deduction for *inventory* purchases. It also lets the taxpayer reduce income by paying off outstanding bills at year-end.

A taxpayer must file an election (choose) to use the *cash basis* of accounting. Once the election (choice) is made, a taxpayer can only switch to the *accrual basis* of accounting with the approval of the CCRA.

Cash basis farmers do have the option of adding an amount to their income up to the *fair market value* of their *inventory*. This allows them to smooth or average income. Using these provisions they can avoid the possibility of not paying any tax in one year, and missing the advantage of the low marginal rates, followed by a year of high taxable income, some of which is subject to the top marginal rates. The provision may also be used to increase income and take advantage of old losses that might otherwise expire.

A recent change to the *cash basis* accounting rules for farmers prevents the deduction for the cost of "purchased inventory" on hand at the end of the year where it results in a loss. This is known as the *mandatory inventory adjustment*.

2. Loss Carryovers. We have already mentioned that losses from a farming business can be carried back three years and forward ten. Losses from other businesses may only be carried back three years and forward seven.

3. Restricted Farm Losses. A business carried on with a

"reasonable expectation of profit" may make losses. But where: "a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income,[5]" the loss from farming that can be used as a deduction against income from other sources is limited to the first $2,500 of loss plus one-half of the next $12,500 for a maximum of $8,750. Any excess (known as a "restricted farm loss") can be carried back three years and forward 10 years, but only used to the extent of farm income in those years. In this way, the benefits from tax losses that often arise in the early years of business, and are accelerated by use of the cash method of accounting, are restricted for part-time or hobby farmers.

Whether farming is being carried on as a hobby or on a part-time basis has been the subject of endless court cases. Generally speaking, the question that must be answered is whether other income generating activities are undertaken to subsidize the farming operation during poor years, or whether the farming activities are being undertaken to supplement a taxpayers income from other sources.

You need to ask:
- How much time is spent farming versus generating income from other sources?
- How much capital is invested?
- What is the gross revenue of the farming operation?
- How much farming experience and knowledge does the taxpayer have?
- Would the income potential of the farming business—as demonstrated by a business plan—be considered in determining whether farming, or farming combined with some other source, is the taxpayer's chief source of income?

4. Investment Tax Credits. Investment tax credits are available for purchases of new equipment and buildings to be used in a farming business in Nova Scotia. They are also available to taxpayers in the logging business. We discuss them in more detail later.

5. Capital Gains/Succession. In many cases, farmers receive favourable treatment on the taxation of *capital gains*. There are also *rollover* provisions for the tax-free transfer of a farming business from parent to child. We will also discuss these in more detail later.

Exercise 3. Tom Eng has just inherited a woodlot. He decides to supplement his income from a local garage with income from the woodlot. Being handy with equipment he decides to purchase a small tractor to use with a trailer to haul wood. In the first year of business he spends $10 000 on a used tractor and his other costs total $2000. Having not sold any wood yet, his loss in the first year is $3500 (tractor depreciation plus other costs). How much of this is he entitled to claim against his income?

(see page 67 for answer)

LESSON TWO QUIZ

Based on your study of this lesson, please choose the best answer.

1. An individual who sets up a proprietorship is not placing his personal assets at risk. T F

2. Under a proprietorship, business income and losses must be kept separate from personal income. T F

3. Under a partnership, a member's personal assets are at risk if the partnership undergoes business failure. T F

4. Under a partnership members must include income from the partnership with their own personal income. T F

5. A corporation must file its own income tax return. T F

6. Partnerships and proprietorships always qualify for the $500,000 capital gains deduction. T F

7. If it is obvious that tree planting, thinning and harvesting are being done on a woodlot within the framework of a woodlot management plan Canada Customs and Revenue Agency will generally consider the woodlot to be a commercial farm woodlot. T F

8. A taxpayer may switch from the cash basis of accounting to the accrual basis of accounting any time that it is convenient without notice or approval. T F

9. The test used by CCRA as to whether a farming operation is to be classed as a part-time or hobby farm is whether or not there is a red barn on the farm. T F

10. One of the benefits of a farming business is that losses can be:
    a) carried back three years and forward indefinitely
    b) carried back ten years and forward three years
    c) carried back three years and forward ten years
    d) deducted from your income

(Answers on page 67)

LESSON 3: MEASURING INCOME

RECORD KEEPING

Anyone carrying on a business is required by law to maintain books and records so that they can determine income and what taxes they must pay. They must also demonstrate the appropriate handling of payroll taxes, sales taxes, workers' compensation, and so on. Keeping books and records generally centres on the bank account. As a rule, corporations and partnerships have a separate bank account through which the business transactions would flow. Although not legally necessary, record keeping for a proprietorship is much simpler if a separate bank account is kept for business transactions.

Record keeping systems are available to suit all levels of complexity. Generally they are designed to document and summarize revenue and expense transactions, and to keep a financial record of investments in assets and business liabilities.

A basic manual record-keeping journal is shown in appendix 2. You enter financial details of business transactions in a multi-column journal, often called a cashbook, as the cash is received or disbursed. You keep separate columns or accounts for each category of receipt or disbursement that is regular or large. This makes it easy to summarize accounts and prepare financial statements from time to time. Cashbooks are available with many columns and, if necessary, the receipt and disbursement transactions may be kept separately.

In this basic manual system, you would keep an "open item file" for accounts receivable invoices and a separate one for accounts payable invoices. When preparing financial statements, you would take listings for businesses using the *accrual basis* and make appropriate adjustments for these unrecorded invoices. Make other adjustments for unpaid wages and other liabilities as well as *inventory* levels.

Start a fresh cashbook each fiscal period. It should be totalled and balanced from time to time—preferably monthly—and posted to a general ledger, which keeps a more permanent record of the business accounts. Regardless of the size of the business, it is important to compare and reconcile the transactions in the cashbook with those on the business bank statements. As business activity grows, you can upgrade to a more sophisticated manual record keeping system. However, a computer system will probably be the practical solution over the longer term.

Although, a basic cashbook and general ledger work well to document and summarize transactions, you must also keep the supporting documents themselves - contracts, expense invoices, revenue invoices, deposit slips, bank statements, cancelled cheques, and so on. These "originating documents" should be retained for at least six years, and journals and ledgers should be retained indefinitely. Documents dealing with items of a long-term nature, such as loan documents, equipment purchases, and so on, should also be kept indefinitely. It is also a good idea to obtain the CCRA's permission before any accounting documents are destroyed. Even then, be cautious, as CCRA's blessing will not influence other government agencies such as workers' compensation authorities.

RECEIPTS/REVENUES

Businesses normally generate their cash flow from one or two main sources; so the variety of cash receipts that a business must account for is quite small. It is often helpful when managing a business to have a more detailed breakdown of these revenue sources, but there is no requirement to do so. A woodlot operator may want to track revenue from hardwood and softwood sales separately, for instance, or keep cedar and spruce sales separate, or track revenue from one woodlot separately from another.

If you need such a detailed breakdown, it can easily be handled with the record keeping system outlined above by adding the appropriate columns to the cashbook. Nevertheless, most cash receipts could be accounted for under the following headings:

- sales revenue/collection on account
- HST collected
- miscellaneous income
- loans received
- other receipts (equipment sales or trade-ins, advances from shareholders, HST refunds, income tax refunds, and so on)

Sales revenues, *sundry income*, and equipment sales are all relevant in determining taxable income.

EXPENSES

Capital costs

Payments on capital assets cannot immediately be deducted for income tax purposes. This is true regardless of whether the taxpayer calculates income using the *cash basis* or the *accrual basis* of accounting. Capital assets tend to be of a long-term nature and provide an enduring benefit. Examples include land, buildings, automotive and other equipment (such as motor vehicles, tractors, chainsaws, winching equipment, skidders), fencing, timberland, and so on. Generally equipment or tools that will be of use for more than one year are considered capital assets and are depreciated over the long-term for income tax purposes.

For practical purposes, an immediate write-off is allowed for a tool costing less than $200. Note that an item that may appear by itself to be a capital item may be deductible as a repair if it is in fact a replacement part or component for a larger piece of machinery. *Inventory* (such as seedlings and plantations, see below) is not considered a capital asset, and neither is the cost of supplies that are consumed in the business.

For income tax purposes, depreciable capital assets are grouped into classes. *Capital cost allowance* (depreciation) is then calculated at *prescribed* rates on a declining balance basis. Only one-half of the normal *capital cost allowance* rate is used on the net additions to a class for any particular year. Net additions are determined by subtracting from the cost of new assets the proceeds of disposal, up to the original cost, of any assets of the same class that were traded-in or otherwise disposed of during the year. The table on the next page shows the use of the capital cost allowance system.

You should note that if all assets in a class have been disposed of, any remaining balance may be written off. This is known as a terminal loss. On the other hand, if the proceeds from the disposal of assets result in a negative balance in the class, this amount gets included in income as *recaptured depreciation*.

Recurring expenses

For a woodlot operation not carried on as a farming business, income must be reported using the accrual method. Generally speaking, recurring expenses directly related to the commercial activity are deductible in the year incurred. Whether a planting, thinning, fertilizing or property tax expenditure is a recurring expense will depend on the particular circumstances. If land is not used in a business in a particular year, the interest and property taxes that can be deducted may be restricted.

Using the Capital Cost Allowance System

	Buildings Class 1 - 4%	Fencing Class 6 - 10%	Office Equipment Class 8 - 20%	Logging & Automotive Class 10- 30%	Logging Truck Class 16 - 40%	TOTAL
Undepreciated Capital Cost, Jan, 20X1	55,225		7,877	76,854		139.956
2001 CHANGES						
Building expansion	17,500					17,500
Investment tax credits claimed in prior year				-3,000		
Purchased new skidder				125,000		125,000
Trade in value of used skidder				-33,000		-33,000
Installed Fencing		1,700				1,700
Purchased new log truck					85,000	85,000
SUBTOTAL	**72,725**	**1,700**	**7,877**	**165,854**	**85,000**	**333,156**
MAXIMUM CAPITAL COST ALLOWANCE						
(55,225 x .04) = (17,500 x .04 x .50)	2,559					2,559
1700 x .10 x .50		85				85
7877 x .20			1,575			1,575
(76,854x.30) + ((125,000-33,000)x.30x.50)				36,406		36.406
85,000 x .40 x .50					17,000	17,000
TOTAL CAPITAL COST ALLOWANCE CLAIM	**2,559**	**85**	**1,575**	**36,406**	**17,000**	**57,626**
Undepreciated Capital Cost, Dec. 31, 20X1	**70,166**	**1,615**	**6,302**	**129,448**	**68,000**	**275,530**
Undepreciated Capital Cost, Jan 1, 20X2	70,166	1,615	6.302	129,448	68,000	275,530
20X2 Changes						
ITC's on 20X1 additions - assumed	-1,750			-12,500	-8,500	
Purchased chain saw				800		800
Sold used half-ton				-4,500		-4500
SUBTOTAL	**68,416**	**1,615**	**6,302**	**113,248**	**59,500**	**249,080**
MAXIMUM CAPITAL COST ALLOWANCE						
68416 x .04	2,737					2,737
1615 x .10		162				162
6302 x .20			1,260			1,260
115798 x .30				34,739		34,739
63750 x .40					23,800	23,800
TOTAL CAPITAL COST ALLOWANCE CLAIM	**2,737**	**162**	**1,260**	**34,739**	**23,800**	**62,698**
Undepreciated Captial Cost, Dec. 31, 20X2	65,679	1,454	5,041	78,508	35,700	186,383

Depletion

Generally, woodlots would be classified as "timber limits." The cost of a "timber limit" includes the cost of the underlying land and may also include the cost of surveys, cruises, maps, and so on. The total cost less the residual value of the land and the cost of surveys, cruises, maps, and so on is depleted when trees are harvested. A deduction for depletion, based on quantity harvested, is calculated by multiplying this "net cost" of the timber by the quantity of wood harvested and dividing by the quantity of timber in the limit as shown by a cruise. A further deduction—equal to one-tenth of the cost of surveys, cruises, maps, and so on—is allowed until their cost has been fully deducted.

For example, let's assume a woodlot owner is beginning to harvest a timber limit. The owner's cost of the timber limit is $45,000, of which $7,500 applies to the residual value of the land. Another $3,500 has been spent on cruises, surveys, and so on. The cruise indicated there were 2000 cords of timber in the limit of which 500 were harvested during the year. In the example below we show how to calculate the deduction for depletion of the timber limit.

Basic deduction

= (Cords harvested / Cords documented by cruise) X (cost of timber limit less residual value of land)

= (500/2000) X ($45,000 - $7,500)

= $9,375

Additional deduction re cost of cruises, surveys, etc.

= Total cost thereof X 1/10
= $3,500 x 0.1
= $350

Total depletion deduction for year is $9,725.

Exercise 4. In 2000 Ian White purchased 100 acres of land for $32,000. The bare land value of the land is $15,000. Prior to purchasing it, he had it cruised which indicated that the land contained 2000 cords of wood. In addition, he purchased a new ATV for $8000 and a skidding sulky for $500. In the fall he cut and sold 16 cords of stud wood and 4 cords of firewood.

(A). Assuming a capital cost allowance of 30% for the ATV and 20% for the sulky and that he bought the ATV for 70% business use and 30% personal use, what deduction can he make for his equipment purchases in 2000.
(B) How much can he claim for depletion for the land?

(see page 67 for answer)

There is an alternative method of claiming depletion for a timber limit in which the lesser of $100 and the amount received in the year for the sale of timber is allowed as a deduction. This method obviously has limited application and benefit, but would apply where the timber resources have not been documented by a cruise.

Inventory
The cost of seedlings and planting represent the cost of *inventory* for tree farmers, and for *cash basis* taxpayers these costs would be deductible as paid. The CCRA's position appears to be that these costs do not represent "purchased inventory" subject to the *mandatory inventory adjustment*. Remember however that *cash basis* farmers can also smooth or average their income by adding to income an amount up to the *fair market value* of their *inventory*. For *accrual basis* taxpayers, these costs would be carried forward and deducted against future revenue. Harvesting costs (including depletion of timber limits for non-farmers) would be treated the same way. If the taxpayer operates woodlots but generally not as a farmer, the costs of seedlings and planting would become part of the cost of the timber limit.

Maintenance and operating costs
Annual maintenance costs such as thinning and spraying should be fully deductible as incurred or as paid, depending on which accounting method you use. Other costs such as labour, equipment operating and maintenance costs, property taxes, office supplies, vehicle operating, and marketing expenses would also be deducted as incurred or as paid. If vehicles are also being used for personal purposes, appropriate adjustments should be made to the expenses claimed by a proprietor. If vehicles used personally are owned by a partnership or a company, taxable benefits will be assessed for personal use.

Interest and taxes
Interest is a deductible expense provided it is paid as a legal obligation on borrowed money that is used to earn income from a business or property. There are some restrictions on the deductibility of interest and property taxes on land not used in the course of the business carried on in the year by the taxpayer. This is for interest only and applies to debt incurred to buy land. It does not apply to debt incurred to purchase equipment or standing timber, or provide working capital.

We can also argue that land that produced no revenue, but was being used to grow trees during the year, was used in the course of business carried on in the year. In this case, interest and property taxes should be deductible. If land is cleared before planting, the cost

is deductible provided the land is used in a farming business. Again, this will be deducted as incurred or as paid depending on which accounting method the taxpayer uses. If the taxpayer is carrying on reforestation but generally not as a farmer, these costs would be capital costs and included in the cost of the timber limit.

LESSON THREE QUIZ

Based on your study of this lesson, please choose the best answer.

1. Persons carrying on a business have no obligation to keep records.
   T F

2. A cashbook shows accounts cash receipts separate from cash disbursements.
   T F

3. A well maintained cashbook eliminates the need to retain supporting documents.
   T F

4. There is no legal need to keep a detailed breakdown of cash receipts by revenue source.
   T F

5. On woodlots where operations are carried out in such a way that the woodlot is not a farming business, income must be reported using the accrual method.
   T F

6. When timber is removed from a woodlot a deduction against income may be claimed.
   T F

7. The timing of claiming costs such as seedlings and planting, depends on the method of income accounting.
   T F

8. If money is borrowed to earn income from a business or property, the interest paid may be claimed as a deductible expense.
   T F

9. The original receipt for the purchase of a new farm tractor could be discarded after _____.
   A) 6 years B) 7 years C) never

10. Examples of capital assets include _____, _____, and _____.
    A) light bulb B) a woodlot C) diesel fuel D) new barn
    E) air filters F) tractor chains.

(Answers on page 67)

LESSON 4: MISCELLANEOUS MATTERS

INVESTMENT TAX CREDITS

Investment tax credits have long been available to farmers and loggers in Nova Scotia. Although they have changed dramatically since they were introduced, they are still available for expenditures on "qualified property." An eligible expenditure must be for a *prescribed* building or *prescribed* machinery and equipment. The asset must be new and unused at the time of purchase. Property that has been previously owned, used as a demonstrator, or leased is not eligible. The asset must be acquired to be used by the taxpayer in Canada primarily (more than 50 percent) in the taxpayer's business of farming or logging. (Use in other industries may also qualify but that is outside the scope of this booklet). Examples of buildings, machinery, and equipment that qualify include nearly all structures, machinery, and equipment used in farming or logging activities, except for cars and trucks designed for use on highways. However, logging trucks weighing more than 7,258 kilograms will qualify.

The available credit is currently calculated at 10 percent of the capital cost of eligible assets.

Capital cost is the actual cost less any other government or non-government assistance received. HST recovered as an "input tax credit" is not included. The credits are available to all taxpayers regardless of the size or legal identity of the business, and can be used to offset 100 percent of federal income taxes payable. If not enough federal taxes are payable against which to claim the investment tax credits, 40 percent of current year credits earned by individuals and certain corporations are refundable. A corporation will not qualify for this refund if it had—or was part of an associated group of companies that had—taxable income of more than $200,000 in the taxation year immediately preceding. Further restrictions to the refund apply to companies (or groups of companies) with more than $10 million in assets.

Investment tax credits earned—but not used to offset federal taxes payable or refunded to the taxpayer—can be carried back three years and forward ten years and claimed against federal taxes in those years.

Here is an example that shows the benefit of investment tax credits.

Let's assume the following:

1. Two individuals, A and B, each acquired a piece of equipment for $50,000 in the year 2000. A uses the equipment in logging (an eligible activity for investment tax credit purposes) whereas B uses the equipment in an ineligible activity (perhaps

construction).
2. In both cases the equipment can be depreciated at a rate of 30 percent for income tax purposes.
3. Both individuals are earning profits and have a *marginal tax rate* of 50 percent.

The tax consequences are shown in the table below. You will see that claiming an investment tax credit will result in lower *capital cost allowance* claims in following years.

At a 50 percent tax rate, one-half of the investment tax credit claimed would get repaid over a long period of time because higher taxes will result from lower *capital cost allowance* claims. But it is important to note that the impact of lower *capital cost allowance* claims will stretch years into the future. If the taxpayer's marginal rate of tax is lower, the effect of lower *capital cost allowance* claims is also reduced.

YEAR 2000	A	B
Income reduction from capital cost allowance		
$50,000 x 30% x 1/2 (in year of acquisition)	$7,500	$7,500
Marginal Income Tax Rate	50%	50%
Tax Reduction	$3,750	$3,750
Investment tax credit claimed: 50,000 x 10%	$5,000	
Total tax reduction	$8,750	$3,750
YEAR 2001		
Income tax reduction from capital cost allowance		
Original cost of equipment	$50,000	$50,000
Subtract: capital cost allowance to date	-$7,500	-$7,500
investment tax credit claimed in prior year	-$5,000	
	$37,500	$42,500
Multiply by capital cost allowance rate	30%	30%
	$11,250	$12,750
Multiply by marginal income tax rate	50%	50%
Income tax reduction	$5,625	$6,375
Undepreciated capital cost available for capital cost allowance in future		
Original cost	$50,000	$50,000
Subtract: investment tax credit claimed	-$5,000	
capital cost allowance to date	-	-
	$26,250	$29,750

Exercise 5. June Williams purchased a new Tractor in 2000 for $30,000. She uses the tractor in a farm business. The tractor can be depreciated at a 30% rate and she has a marginal tax rate of 25%. What would her income tax reduction be for the year 2000?

(see answer on page 67)

CAPITAL GAINS

Capital gains tax was introduced in Canada at the end of 1971. Since then several changes have been made to the inclusion rate. Various programs have also been used to provide relief from *capital gains* tax to encourage investment in general and investment in farms and small business in particular.

Capital Gains Deduction

An "enhanced" *capital gains* deduction of $250,000 is available for *taxable capital gains* acquired on qualified *farm property* or on *qualified small business corporation shares*. This means that an actual *capital gain* of $500,000 would be a $250,000 *taxable capital gain*, as the inclusion rate is 50 percent.

The "basic" *capital gains* deduction was removed in 1994. However, taxpayers could choose to dispose of and reacquire *capital property* as at February 22, 1994. By doing so they could increase the *adjusted cost base* of *capital property* and use the "basic" *capital gains* deduction to shelter any resulting gain. An increased *adjusted cost base* reduces the *capital gain* that will be acquired when property is eventually disposed of. If an individual's basic *capital gains* deduction (eliminated in 1994) was used against *taxable capital gains*, this reduces the amount of gains that can be sheltered with the "enhanced" deduction. If no amount were ever claimed under the "basic" deduction rules, the full $250,000 ($500,000 x 50%) continues to be available to farmers and small business owners on the *disposition* of qualified *farm property* or *qualified small business corporation shares*.

A gain is eligible for the "enhanced" *capital gains* deduction if it was acquired on an asset that falls

within the very technical and very specific definitions of qualified *farm property* or *qualified small business corporation share*. For example, a share of a *Canadian controlled private corporation* must meet the following tests to be considered a *qualified small business corporation share* eligible for the "enhanced" deduction:

Test one: Throughout the preceding 24 months, at least 50 percent of the *fair market value* of the company's assets were used principally for carrying on an active business, primarily in Canada.

Test two: At the time of *disposition*, at least 90 percent of the *fair market value* of the company's assets were used principally for carrying on an active business, primarily in Canada.

There are other tests that concern the residency of the shareholder, the period of time the shares have been owned, and so on. The rules also get more complex when intercorporate investments are part of the corporate organizational structure (e.g. holding companies and/or intercorporate investments or accounts between sister companies). Nevertheless, the two most significant and problematic tests are those identified above that deal with the nature and use of the company's assets—with the 90 percent test at the time of sale often being the most troublesome.

Excess cash, rental properties, or personal use assets can disqualify a company from the "enhanced" deduction. But with proper planning, a company can often be "purified" (have its inactive assets removed) before a *disposition* so that the 90 percent test is met.

Very generally, qualified *farm property* refers to land and buildings used in farming by an individual, a share of the capital stock of a "family farm corporation," or an interest in a "family farm partnership." For real property used by a proprietorship, there are holding period, usage, and in some cases gross revenue tests. The rules for interests in "family farm partnerships" or a "share of the capital stock of a family farm corporation" are similar to those for a *qualified small business corporation share*. This means that—as well as residency, holding period, and other tests—eligibility is determined by examining the extent to which the assets of the partnership or company are used in the business of farming.

A taxpayer who has been making losses on investment may have what is called a "cumulative net investment loss" account. This account is essentially the total of investment expenses or losses since January 1, 1988 less investment income earned during that time. Examples of deductions that may give rise to such an account are

rental losses and interest expense on funds borrowed for investment purposes. A balance in this account will affect any claim for a *capital gains* deduction. This means that the *capital gains* deduction is not allowed until enough *taxable capital gains* have been included in income to offset any "cumulative net investment loss" balance.

We must also consider *alternative minimum tax*[6] in connection with the *capital gains* deduction. When large *capital gains* are sheltered by the *capital gains* deduction, the *alternative minimum tax* rules may result in a tax liability. Although you should be aware of this as you are planning transactions, it is important to note that this tax is refundable in future years when a taxpayer's regular tax is less than the *alternative minimum tax*. Also, a gain can often be spread out over two or more years so that *alternative minimum tax* implications are avoided altogether; and the rules do not apply for the year of death. So, *alternative minimum tax* should always be considered and planned for, but is usually not a deal breaker.

Using the "enhanced" *capital gains* deduction on the *disposition* of a business can result in tremendous income tax savings. The taxes that can be saved on a $500,000 *capital gain* are about $190,000 at the top marginal rates. $500,000 may seem like a large gain, but if significant real estate holdings are held for a long period of time, substantial gains can be acquired. The rules are very complex and careful review and planning are needed to capitalize on this tax saving opportunity.

CHANGE-OF-USE

As we mentioned before, when a taxpayer who has owned a woodlot without being in business decides to harvest the wood themselves they may have a deemed (assumed) sale and repurchase of the woodlot at *fair market value*. This "change-of-use" and the income tax rules associated with it depend on changes in the taxpayers' intentions and/or activities with respect to the property.

Presumably the gain resulting from the deemed sale on the property changing from personal use to business use would be a *capital gain*. The taxpayer then has an increased cost base in the property that should be depreciable, as we discussed earlier for timber limits. But if the timber is part of a timber limit, the stepped-up cost base is reduced for depreciation purposes by the non-taxable portion of the *capital gain* (now 50 percent), as well as any taxable portion that has been sheltered by the *capital gains* deduction. Tax deductions are only allowed when expenditures are actually made, or when items included in income actually result in additional tax.

If the change in use is from personal use property to farm *inventory*, the rules may have different consequences. If the taxpayer is using the *cash basis* method of accounting no payment has been made for the cost of the *inventory* and no deduction would be allowed in computing business income. The end result of such a change-of-use may be a *capital gain* at the time of the change with no increased deduction against business income as the timber is harvested. You should note that such a change (capital personal use property to farm *inventory* prior to harvesting) would be very difficult to prove.

GOVERNMENT GRANTS

The general rule is that all government grants are included in income from a business[7]. But if the grant relates to the cost of acquiring *capital property* or an outlay or expense incurred, the taxpayer may elect (choose) to offset the grant against these amounts[8].

So, for a woodlot owner, a grant received could only be excluded from the calculation of the current year's income if it was used for the actual purchase or planting of a timber limit (or perhaps the purchase of a piece of machinery) and the taxpayer elects to apply the grant against the cost of the limit (or machinery). If the grant was used for ongoing maintenance operations, it would either be fully included in income—with any expenses incurred fully deducted—or it would be offset against the expenses with the net expenses being deducted. These alternative methods produce the same results.

YEAR END

Since 1995, unincorporated businesses (proprietorships and partnerships) have been required to have a calendar year end (December 31) for tax purposes. Any remaining portion of the "ten-year reserve" (which eased the increased tax burden that resulted from the switch from an off-calendar year end to a calendar year end) must be brought into income if the proprietorship or partnership becomes incorporated.

INCOME SPLITTING

In Canada, family members are, mostly, taxed independently on their income. This—combined with the graduated personal income tax rates—provides an opportunity and an incentive to reduce income taxes by spreading income among family members. Taxpayers and their advisors have devised various ways of splitting income, and the Department of Finance has been busy blocking those methods that they find offensive.

Nevertheless, there are still many valid methods. For woodlot owners, probably the most relevant way to

split income is to pay a reasonable salary or wages to spouses and children. Another is to have family members participate in the ownership of a business carried on through a corporation. Dividends can then be sprinkled among the spouse and children over 18, resulting in lower overall taxes. (This method requires careful planning, as there are pitfalls).

Other methods, which are not specific to woodlot owners, include making spousal RRSP contributions and spending the earnings of the higher income spouse—while the lower income spouse saves and invests. This results in investment income being taxed at a lower rate.

The benefits of income splitting are shown in this example. Let's assume that an individual operates a woodlot and has a taxable income from it of $45,000. The individual's spouse works part-time outside the family business and has a taxable income of $15,000. The spouse also participates in the family business by keeping books and financial records, answering phones, delivering messages, doing odd jobs, and generally helping as much as possible. The spouse has not been paid a salary or wage for these services. By paying the spouse a $15,000 salary and reducing the individual's taxable income by the same amount, the family's total income is unchanged. But there is a big impact on the family's income taxes. This impact is shown in an example below.

1. Reduction in individuals' income taxes by reduction of taxable income from $45,000 to $30,000.
$15,000 X 36.95%[1] = $ 5,543

2. Increase in spouse's income taxes by virtue of increase in taxable income from $15,000 to $30,000.
$14,590 x 25.77%[1] = $ 3,760
$410[2] x 30.95%[1] = 127
3,887
Total income tax savings = 5543 - 3887
= **$1,656**

1. See appendix 1 for marginal income tax rate.
2. Note change in marginal income tax rate as taxable income reaches $29,590.

CLAWBACK

Several federal programs are subject to an income or means test. For instance, individuals over the age of 65 are generally entitled to Old Age Security (OAS). For the year 2000, this amount was about $422 per month ($5,066 per year). But as a senior's income rises above $53,960, the OAS is clawed back. The amount clawed back is 15 percent of the amount by which the individual's net income exceeds $53,960. So, in the year 2000, an individual's OAS will be completely repayable (clawed back) when their income reaches $87,734 [($87,734 - $53,960) x 15% = $5,066].

The age tax credit of $3,531 available to seniors is also subject to an income test. This credit against federal taxes is eroded as income increases above $26,284.

The credit is reduced by 15 percent of the amount of net income of more than $26,284, until it is fully eroded. Once an individual's income level is more than about $49,824 they will no longer be entitled to any age tax credit.

Other federal programs that are influenced by family income levels include the "guaranteed income supplement," the "family benefit system" and the "goods and services tax credit." Many woodlot owners (particularly those who sell stumpage) do not have a regular income from the woodlot. So, they need to consider how irregular income levels affect the benefits available under these federal programs.

You can use one of two strategies to minimize the effects of these *clawbacks*. The first is to spread income over several years to avoid any unnecessary *clawbacks* altogether. The second is to crowd as much of the income as possible into one or two years so that the benefits will be lost for only a short period of time. When choosing a strategy you should consider your income from other sources, the corresponding *marginal tax rate*, and how much income will be made from the woodlot.

LESSON FOUR QUIZ

Based on your study of this lesson, please choose the best answer.

1. A brand new tractor purchased to work on the farm and in the woodlot is an asset for which an Investment Tax Credit may be claimed. T F

2. The Capital Gains Tax was introduced in Canada in 1994. T F

3. The "enhanced" capital gains deduction was eliminated in February 1994. T F

4. The "enhanced" capital gain deduction can only be claimed once rigid tests are met. T F

5. When large capital gains are sheltered by the capital gains deduction there is no possibility of income tax owing. T F

6. Changing the use of a property from personal to business may result in an unexpected capital gain. T F

7. Grants received from government may have to be reported as income. T F

8. Income splitting within a family unit can result in a substantial reduction of income tax owed. T F

9. Senior citizens who are receiving O.A.S. and are thinking about selling stumpage from their woodlot should consult with a Tax Advisor well in advance of the stumpage sale. T F

10. While sheltering a large capital gain by a large capital gains deduction the _____ may trigger a tax liability.
    A) enhanced capital gains tax B) alternative minimum tax rule
    C) General Avoidance Rule

11. Senior citizens receiving O.A.S. begin to lose benefits under O.A.S. after their net income exceeds _____.
    A) $53 960 B) $26 284 C) $49, 824

(answers are on page 67)

PART 2: ESTATE PLANNING

LESSON 1: INTRODUCTION TO ESTATE PLANNING

THE NEED FOR ESTATE PLANNING

This section is intended for people who own woodlots and want to plan for the future. It will help owners develop a clear plan of how to pass the woodlot on to a spouse or a child.

Often people die without making plans for the future. This can cause confusion and sometimes legal or other costs at a difficult time for the family. Sometimes it can result in significant taxes being due from the estate that could have been reduced or avoided.

For these reasons, estate planning is essential. Here we will deal with the most common situations and problems that you might encounter. We will outline the background of estate planning and explains terms. We will also discuss various strategies that may reduce taxes on death.

We will explain estate planning for woodlot owners in a general way. We will not deal with all situations. Estate planning can be complex, so you are urged to seek advice about your specific situation. Planning now can make your wishes happen when you are gone.

You will save time and money if you gather all the necessary materials before you visit an advisor, or begin to plan your estate. As you work through this section, you should have the following materials:

- family details: age, marital status, involvement in woodlot or other business interests
- current Will if you have one
- list of assets: cost, V-day value if applicable, and market value
- any appraisals or other valuation information
- list of liabilities: amounts, security given, and repayment terms
- details of form of ownership of assets: personal, corporate, partnership
- financial statements and tax returns for several years
- details of life insurance policies

THE ESTATE PLANNING PROCESS

Setting Objectives

The starting point for any estate plan is to determine your objectives. You need to know where you want to go before you can develop a plan to get there. As the planning process unfolds, it will become clear what you can and cannot do. It will also become clear that you may need to modify some of your objectives. But you should start out with a general idea of what you want to do.

The first objective of most estate plans is to provide adequate cash flow to your spouse or any dependents. Other common objectives are to maintain family ownership of a particular asset such as a family business or a woodlot, or to have the ecological features of the woodlot preserved by donating it to—or granting an easement to—a conservation authority.

Most people are concerned that they treat their children equitably, or fairly. Equitably does not necessarily mean equally. You do not have to subdivide your woodlot so each of three children gets a small woodlot of their own. And, it makes little sense to transfer an interest in a woodlot to a child who has no interest in managing it—especially if another child does. Equitable treatment might involve leaving the woodlot to one child and cash to another.

List your estate planning objectives below:

1. _____
2. _____
3. _____
4. _____

Listing Assets

To plan your estate you have to know what it will consist of. You need to make a list of all your assets. Some things, such as household effects, can be grouped by type. But any asset that might be disposed of individually should be listed individually. A woodlot, for example, would be listed individually.

As well as identifying the assets themselves, you need to estimate the *fair market value* of each one. In some cases it is worth getting formal valuations or appraisals but in many others you can make a reasonable estimate yourself. Knowing the value of your assets makes an even-handed distribution of your estate easier. It also makes it easier to estimate the taxes payable.

It is important to list the original cost of the assets. This is used to calculate the tax liability. This information can be difficult to find, so the estate planning process is a good opportunity to create an accessible record.

List each of your assets along with its fair market value, original cost, and difference.

Asset	*Fair Market Value ($)*	*Original Cost ($)*	*Difference ($)*

List any liabilities with security given, value, and repayment terms.

Liability	*Amount Owing ($)*	*Security Given*	*Repayment Terms*

Listing Liabilities

Your estate consists of your assets minus your liabilities. For older woodlot owners taxes may be the only significant liability, but for younger people that may not be the case. They may have mortgages on land, or still owe money on equipment. Part of the process of planning your estate is to develop a plan to deal with your liabilities at death.

DEVELOPING AND IMPLEMENTING THE PLAN

With this information you are ready to develop a working plan. Modify your objectives as it becomes clear what is practical and rework the plan until it meets your needs and wishes.

Information about things to consider when planning your future can be found in Lessons Two and Three. You should refer to this information when developing your plan.

Implementing the plan often just requires a fairly simple Will. More complex situations might require the formation of trusts or corporations, reorganizing existing corporations, acquiring life insurance and so on.

LESSON ONE QUIZ

Based on your study of this lesson, please choose the best answer.

1. Careful estate planning could reduce taxes that the estate is liable for.
   T F

2. Estate planning eliminates the need to outline a set of objectives that show how you want your estate to be distributed. T F

3. Estate planning includes making a list of all the assets you own or have an interest in. T F

4. Older woodlot owners do not have to be concerned about their liabilities, during their estate planning. T F

5. In calculating the tax liability of an asset, _____ is subtracted from _____.

   A) original cost $ B) FMV $

(answers are on page 68)

LESSON 2: ESTATE PLANNING TOOLS

WILLS

Your Will is the basic document in estate planning. The Will determines how the estate will be distributed. In it you can direct that a specific property (including a woodlot, a favourite fishing rod, or a specific amount of cash) go to a certain person. The Will also determines the distribution of the rest of your estate—the residue that is left after specific bequests have been dealt with.

More complex Wills can provide for the establishment of various trusts and may give very specific direction as to the *disposition* of assets. That is, your Will may specify exactly how and when your assets will be disposed of, who gets them, and under what conditions.

In your Will you appoint an *executor* to manage your estate. You can have co-*executors* if you feel more than one person is required to carry out your wishes. An *executor* is generally a family member, but can be a friend, a lawyer, or a trust company. Being an *executor* is a serious responsibility so you should choose yours carefully, and you must be sure they are willing to accept the appointment. The Will should give the *executor* the power to make any income tax elections (choices) that they deem advisable.

Your spouse has an interest in all of the family's assets under the *Matrimonial Property Act*. She or he is entitled to enforce the scheme of distribution of property under the Act rather than following the terms of the Will. In other words, what you put in your Will may be over-ridden by the rules of this Act, unless a marriage contract is in place. So, it is important to involve your spouse in the whole estate planning process.

If you die without a Will, or *intestate*, your estate will be distributed according to a statutory plan. If you are survived by a spouse, the first $50,000 of your estate goes to the spouse. If your spouse and one child survive you, the spouse and child would share equally in any part of the estate over $50,000. If two or more children and a spouse survive you, one-third of the assets over $50,000 go to the spouse and two-thirds to the children.

This may not be what you wish. And it may cost more in income tax than a planned estate. It will also be a difficult and costly situation for your family. That is why planning should include everyone who might be affected by the provisions of your Will.

You can write a Will on a piece of paper or you can buy a kit that shows you what to do. But most

lawyers charge fairly modest fees for a simple Will, and it is probably worth the cost to be sure it is done right.

TRUSTS

A trust is a relationship where one person (the *trustee*) holds property for the benefit of another person (the *beneficiary*). There can be more than one *trustee* and/or more than one *beneficiary*.

A trust is created by a person called the *settlor*. The *settlor* transfers property to the trust by means of a trust agreement. The trust agreement governs how the trust will operate, including how income and capital will be distributed. Each trust agreement is unique and this provides quite a bit of flexibility. The *settlor* can also be—and very often is—a *trustee*. He or she can also be a *beneficiary* but this is uncommon.

The *beneficiary* of a trust owns the trust but does not manage it. Trusts are used in specific situations, such as when transferring property to a minor child. A trust is often used to manage an investment portfolio for the benefit of a spouse or child who lacks financial skills or responsibility. Another use of a trust would be to transfer a woodlot to children who are not yet ready to manage it.

The drawback of using a trust is that the transfer of property to the trust is a *disposition* of property and may create some immediate tax liability. This is something you can discuss further with your professional advisor.

One particular type of trust is referred to in the Income Tax Act as a *spouse trust*. A *spouse trust* is a trust where no one but the spouse may benefit from the income or capital of the trust during the spouse's lifetime. When the spouse dies, the remaining capital of the trust is distributed to the remaining beneficiaries, usually the children.

A *spouse trust* is used to provide income for the spouse to live on, while passing the capital (the original money in the trust) on to the next generation.

THE TAXATION OF CAPITAL GAINS

A *capital gain* (or loss) occurs when a taxpayer disposes of a *capital property*. A *disposition* includes a sale, a gift, or any other transaction where the "beneficial ownership" of the property changes. If you give your son your house, he takes on the beneficial ownership of the house, for example.

There are also a number of situations where the Income Tax Act deems that a *disposition* has taken place. That is, there are times when it is assumed, or deemed, you have disposed of your property. For estate planning purposes, the most important of these is that you are deemed to have disposed of all of your property when you die.

All disposals have *proceeds of disposition* or deemed *proceeds of disposition*. Generally, this is the money that was received for the property disposed of, usually simply the sale price of a property that has been sold. The proceeds can be zero, as when a property is destroyed or a debt goes bad.

Exchanges of property will also produce *proceeds of disposition*. If you exchange properties with another person you will have *proceeds of disposition* equal to the *fair market value* of the property you receive. That is, if you exchange your woodlot for your friend's house, which is worth $80,000, you will have *proceeds of disposition* of $80,000.

To determine the amount of a *capital gain* or loss, you take the *proceeds of disposition* and subtract from it the *adjusted cost base* of the property and any costs of *disposition* (legal fees, real estate commissions, and so on). There can be a number of complex technical adjustments, but in most cases the *adjusted cost base* of a property is simply its original purchase price.

There are two important exceptions to this rule. The first is a property that has been inherited. As we noted above, if a parent has bequeathed a property to you, they are deemed to have disposed of that property for proceeds equal to the *fair market value* of the property at the time. Their deemed proceeds become your deemed cost.

The other exception is a property that you owned on December 31, 1971. This was the day before *capital gains* became taxable in Canada and is referred to as *Valuation Day* or V-Day. There are two ways to calculate the *adjusted cost base* of a property owned on V-Day.

The basic way is by using the *median rule*. Using this method you find the *adjusted cost base* by working out which of these three amounts—the cost, the *proceeds of disposition*, or the *fair market value* on *Valuation Day*—has a value that falls in between the other two—this is the median. Usually this will work out to be the V-Day value. The other method (which most people use) is to elect (choose) to use the V-Day value—that is, the value from December 31, 1971.

Only one-half of a *capital gain* is taxable (for gains acquired after October 18, 2000). This *taxable capital gain* is included with your other income and taxed at your *marginal tax rate*. There is no specific "Capital Gains Tax."

If the *adjusted cost base* plus the costs of *disposition* exceed the *proceeds of disposition*, then there is a *capital loss*. The allowable *capital loss* is one-half of the loss. Gains and losses are netted—or offset—against each other for the

year. If there is a net loss, it can be carried back one year and forward indefinitely. A *capital loss* can only be deducted against *capital gains*.

Your principal residence is a special type of *capital property*. It includes your house plus one acre, unless you can demonstrate that more land is required for the use and enjoyment of the property. An example of a need for more land would be a zoning by-law that requires a minimum lot size. A gain on the *disposition* of your principal residence is not taxable. This is true even for any gain that might result from a deemed *disposition* on death.

Here are two examples of how the *capital gains* rules work.

Example 1. Let's assume you purchased a woodlot in 1962 for $1,000. At December 31, 1971 it was worth $4,000. In 2001 you sold it for $50,000 and paid a real estate commission of $2,500 on the sale.

Your *proceeds of disposition* would be the sale price of $50,000

There are two ways you could arrive at your *adjusted cost base*.
By the *median rule* method, the *adjusted cost base* would be the median (middle) amount of the cost of $1,000, the V-Day value of $4,000, and the *proceeds of disposition* of $50,000 (here this is the V-Day value of $4,000).

By the V-Day value method the *adjusted cost base* would simply be the V-Day value of $4,000.

In our example the two methods produce the same result; an *adjusted cost base* of $4,000 and a gain of $ 46,000. From the above result we subtract our cost of *disposition*, the commission of $2,500. This leaves us with a *capital gain* of $43,500.

The *taxable capital gain* included in your income is 50% of this or $21,750.

Example 2. Let's assume you purchased a woodlot in 1976 for $8,000 and it is worth $60,000 today. You decide to give the woodlot to one of your children.

Your *proceeds of disposition* will be the *fair market value* of $60,000 .

Your *adjusted cost base* is the purchase price of $8,000.

You have no costs of *disposition*, so your *capital gain* is $52,000.

And your *taxable capital gain* is 50% of that or $26,000.

DEALING AT ARM'S LENGTH

The Income Tax Act refers many times to dealing at *arm's length*. People deal at *arm's length* when they have separate and opposing economic interests. The Income Tax Act deems (assumes) that related persons do not deal at *arm's length*. Related persons are your parents, children, spouse, in-laws and any corporation that you or they control. Unrelated persons may not necessarily be dealing at *arm's length*, but this depends on the facts of the situation.

The importance of the concept of *arm's length* is that transactions between persons not dealing at *arm's length* are deemed to take place at *fair market value* rather than the notional transaction price. The effect of this is that if you leave your woodlot to your children, you will be deemed to have disposed of it for its *fair market value*.

ROLLOVER PROVISIONS IN THE INCOME TAX ACT

There are a number of provisions in the Income Tax Act that tax specialists refer to as *rollovers*. A rollover is a transaction where property is transferred at the transferor's tax cost so that no immediate tax cost results. The transferee inherits the transferor's tax position. You should note that these transactions are not tax-free but tax-deferred, as tax will be payable when the property is finally disposed of. There are rollover rules to allow the incorporation of a business.

SPOUSAL ROLLOVERS

The general rule is that, when you die, you are deemed to have disposed of all of your property at its *fair market value*—except for property that passes to your spouse or to a *spouse trust*. This property is deemed to be disposed of at your *adjusted cost base*.

If you transferred property to your spouse during your lifetime, it is treated the same way. It is deemed to be disposed of at your *adjusted cost base*. Complex rules known as *attribution rules* prevent the transfer of income and *capital gains* between spouses. These are best explained by a tax specialist, but here is a simple example:

If your woodlot cost $5,000, say, and is now worth $40,000 you could transfer it to your spouse with no immediate tax cost. You would be deemed to have disposed of the woodlot for $5,000 so you would have no gain or loss. Your spouse would be deemed to have a cost of $5,000. If your spouse then sold the woodlot for $40,000, there would be a $35,000 *capital gain* of which one-half ($17,500) would be taxable.

If you had transferred the woodlot to your spouse during your lifetime, the *taxable capital gain* would be included in your income. If the actual sale takes place after your death, the gain will be included in your spouse's income—regardless of

whether the property passed to your spouse during your lifetime or on your death.

Your *executor* can elect out of the *adjusted cost base* rule and have property deemed to be disposed of at *fair market value*. This can be useful in some situations—for example, when there are unused *capital losses*.

Unused *capital losses* can only be applied against *capital gains*. If the property passes to your spouse under the normal *adjusted cost base* rule, there will be no *capital gain* and your spouse will be subject to a larger *capital gain* when he or she disposes of the property.

FARM PROPERTY

There are two provisions in the Income Tax Act that make it possible to transfer qualified *farm property* from parent to child (inter-generational transfer).

Firstly, if a child inherits qualified *farm property* from his or her parent, the parent is deemed to have received proceeds for land equal to the *adjusted cost base* of the land. If *depreciable property* is transferred to the child, the parent's deemed proceeds are the *undepreciated capital cost* of the property. So no *capital gain* or *recaptured depreciation* results. The child's *adjusted cost base* is equal to the parent's deemed proceeds—so the child simply steps into the parent's shoes. No change occurs in the tax situation of the property.

Secondly, a parent can also transfer property to the child on a *rollover* basis during his or her lifetime. In this case there is some flexibility in the transfer value, and the actual proceeds of the disposal are a factor. We will look at some simple examples below, but you may need professional advice to do a proper *rollover*.

The possible values for a *rollover* range from the *adjusted cost base* to the *fair market value* (assuming the *fair market value* is higher). If the actual proceeds are less than the *adjusted cost base*—for example, when the property is gifted to the child—then the deemed proceeds are the *adjusted cost base*.

If the actual proceeds are more than the *fair market value*, the *fair market value* becomes the deemed proceeds. If the actual proceeds are between the *adjusted cost base* and the *fair market value*, the actual proceeds and the deemed proceeds are the same.

This allows the transfer of *farm property* to a child on a tax-deferred basis. At times, it is a good idea to trigger a gain in the parent's hands to step up the cost base to the child. A parent would do this if they had access to the *capital gains* deduction or had unused losses. They would set the proceeds within the

allowable range at a level that would produce the desired gain. That way, the losses and gains would cancel each other out.

Although this may be desirable, the parent may want to give the property to the child. If so, the child could give the parent a promissory note for the purchase price. The parent would then bequeath the note to the child.

For example, let's assume that your woodlot is a Christmas tree plantation that you bought in 1981 for $7,000. You have been harvesting trees over the years. The property is now worth $30,000. If you die and your child inherits the woodlot you will have deemed *proceeds of disposition* equal to your cost, $7,000. You will have no gain or loss and your child's cost of the property will be deemed to be $7,000.

If you gave your child the woodlot during your lifetime, the result would be the same—there would be no gain or loss for you and a cost of $7,000 for your child.

Now let's assume the same scenario, only you have a *capital loss* from previous years of $7,500, and you have not had a *capital gain* against which you could deduct this loss (remember *capital losses* can only be deducted from *capital gains*). Instead of giving the woodlot to your child (in which case it must be transferred at your cost) you could sell the woodlot to him or her.

You can set the selling price anywhere between your cost ($7,000) and *fair market value* ($30,000), but you must receive consideration (payment) equal to the selling price. Typically, in this situation the consideration is a note payable from the child. You have the right to demand payment within the terms of the note, but you may choose to hold the note and gift it back to the child in your will, with no tax implications.

Forgiving the note during your lifetime may trigger tax for your child. If you set a selling price of $22,000 you would pay no tax, because your *capital gain* on the sale would be completely offset by the *capital loss* you have. Your *capital gain* is calculated as follows: (Selling price - cost) x 1/2 = ($22,000-$7000) x 1/2 = $7500. The cost of the property to your child would be $22,000, instead of $7000 in the first example. This would reduce your child's taxes when he/she eventually disposes of the property.

Exercise 6. Joanne White bought a woodlot in 1987 for $10,000. The property is now worth $20,000.
A) Considering tax implications for her and her daughter, is it best to give the woodlot to her daughter now or will it to her when she dies?
B) If Joanne has incurred a capital loss of $5000 from previous years, would this change things? If so, how?

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

(Answer is on page 68)

There are other *rollover* provisions in the Income Tax Act that can be useful in estate planning. These include the rules for transfer of property to a corporation in subsection 85(1) and for reorganizations of capital in section 86.

THE CAPITAL GAINS DEDUCTION

The general $100,000 lifetime *capital gains* deduction was repealed effective February 22, 1994. Individuals could elect (choose) at that time to use the deduction and increase the *adjusted cost base* of their woodlot or other property. This reduced the *capital gain* that may occur when the property is actually disposed of.

Although the general deduction is gone, the "enhanced" $500,000 *capital gains* deduction available for certain types of property is still available. The full *capital gains* deduction of $500,000 will completely shelter the tax on a $250,000 *taxable capital gain*.

This applies to two types of property. The first is qualified *farm property*. Qualified *farm property* includes: land or *depreciable property* used by the taxpayer, a spouse, or their children in the business of farming; an interest in a family farm partnership; or shares of a family farm corporation.

A family farm corporation is one in which all, or substantially all, of the assets of the corporation, at *fair market value*, are used in a farming business in Canada. (CCRA defines "substantially all" as 90 percent). If the property was acquired after June 17, 1987, you must meet a gross revenue test for it to be qualified *farm property*.

Although the *capital gains* deduction for qualified *farm property* is obviously very important when planning for farms that have woodlots, some woodlots—as we pointed out earlier—will also be qualified *farm property*. CCRA has stated that a Christmas tree farm, a maple products operation, reforestation, and other types of woodlots could be farming property and so qualify for the *capital gains* deduction.

The $500,000 *capital gains* deduction also applies to *qualified small business corporation shares*. These are shares of a *Canadian controlled private corporation* all, or substantially all, of the assets of which are used in an active business carried on primarily in Canada. The shares must be held for at least two years, and at least 50 percent of the corporation's assets must be used in an active business carried on primarily in Canada during those two years. The rules become more complex if several corporations are involved. There is an exception to the two-year holding period when you incorporate a previously unincorporated business. If the assets you transfer to the corporation are all used in the business, then the shares qualify immediately.

Earlier we mentioned subsection 85(1), which allows the transfer of assets to a corporation on a tax-deferred basis. This allows incorporation of a business without an immediate tax cost.

If you have been actively managing your woodlot, you could transfer it to a new corporation. Then you could sell the shares and use the *capital gains* deduction.

Corporations that have been in business for some time often acquire property that is not used in the business (investments in securities or real estate, for example). These investments may not qualify as shares of a family farming corporation or a *small business corporation*. There are ways to "purify" a corporation so its shares will qualify for the *capital gains* deduction. Seek further advice if you wish to do this.

CRYSTALLIZATION

Taxpayers are always concerned that the enhanced *capital gains* deduction will be replaced, or that the shares of a corporation will not qualify at the time a *disposition* occurs. To avoid this, the *capital gains* deduction can be crystallized. This is done by making a transaction that will trigger a *capital gain* that is sheltered by the *capital gains* deduction but which increases the *adjusted cost base* of the property by the amount of the gain.

Examples of *crystallization* transactions include transferring a woodlot that qualifies as a farm to a

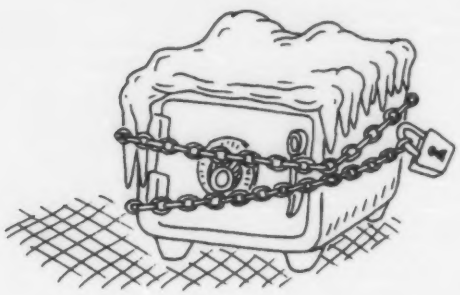
trust for the benefit of your children, or reorganizing the share capital of a *small business corporation*.

Crystallization transactions should not result in any income tax payable, but they do result in an increase in net income that can cause a *clawback* of Old Age Security or a loss of the Guaranteed Income Supplement. They can also result in *alternative minimum tax*. You should consider all these factors when planning this type of transaction.

These transactions, like those that are used to purify a corporation, are complex and should not be undertaken without professional advice.

ESTATE FREEZING

If you own an asset that will increase in value over time, and you have taken as much advantage of *rollovers* and the *capital gains* deduction as you can, then an *estate freeze* may be in order.



Estate freezes typically involve a corporation, although where the *capital gains* deduction is available, a trust might also be used.

In a typical *estate freeze*, the parent transfers the appreciating asset to a corporation using the *rollover* provisions in 85(1). The parent will usually take back debt from the corporation up to their *adjusted cost base* and preferred shares for the balance of the *fair market value* of the transferred asset. The preferred shares will have a built-in *capital gain*. There is no way for the parent to avoid the gain that has already accrued.

The value of the parent's debt and preferred shares is fixed, so any future appreciation in the asset will accrue to the holders of the common shares of the corporation. The children usually hold these shares, but some might be held by the spouse in certain circumstances.

The parent will normally hold a class of shares that has only a nominal value but a high number of votes, so that they control the corporation during their lifetime.

LIFE INSURANCE

Life insurance can serve a number of purposes in estate planning.

If you die it can provide cash flow to allow your spouse and dependents to maintain their

lifestyle while they are still young. It can provide ready cash to pay estate liabilities—you may have significant liabilities that will need to be met from estate funds. Later on, it can provide the cash to pay taxes rather than forcing your survivors to sell a property you wish to remain in the family.

Finally, many people simply want to leave something to their children. Life insurance is a way for you to save up this inheritance and be sure that it will be paid if you die prematurely.
All life insurance policies have a *beneficiary* or *beneficiaries*. Usually the *beneficiary* is a specific person or persons, but it can also be your estate. If it is your estate, control of the proceeds of the policy is dealt with by your *executor*.

LESSON TWO QUIZ

Based on your study of this lesson, please choose the best answer.

1. Estate planning eliminates the need for a will. T F

2. Under provincial statutes Wills provide the authority for a spouse to distribute their estate to non family members as they wish. T F

3. Passing away without a will is referred to as dying _____.
A) in estate B) in testate

4. The person who creates a trust is known as a _____ .
A) trustee B) beneficiary C) settlor

5. On passing away one is deemed to have disposed of all property. T F

6. The amount of a capital gain is calculated by subtracting the _____ and the _____ from the _____.
A) proceeds of disposition B) adjusted cost base C) costs of disposition

7. Rollover transactions have a principal benefit of deferring tax into the future. T F

8. Rollover provisions exist that allow a transfer of farm property from a parent to a child on a tax-deferred basis. T F

9. On February 22 1994 the $100,000 lifetime capital gains deduction was increased to $500,000. T F

10. A maple products operation can not be considered as a qualified farm property. T F

11. If one was concerned that future amendments to the Income Tax Act would remove the enhanced capital gains deduction then it would make sense to explore a transaction known as crystallization. T F

12. With comprehensive estate planning there is no point in having life insurance. T F

(answers are on page 68)

LESSON 3: OTHER THINGS TO CONSIDER WHEN PLANNING YOUR FUTURE

THE NEED FOR LONG-TERM CARE

You may—particularly later in life—require long term care services. These services could be provided at home or in a residential facility such as a nursing home or special care home. They can be very expensive. If you are unable to pay for these services yourself, then you may receive assistance from the Department of Health.

The Department of Heath has a standard method of assessing whether or not you are eligible for financial assistance for the costs of long-term care. Your income and net assets—that is, your assets minus any liabilities—are taken into account. Your spouse's income and assets are also considered.

For assessment purposes, woodlots are classified as real property. Real property—other than a designated primary residence—is included in the calculation of net assets when assessing your eligibility for assistance for the cost of long-term care. So, you will be required to make some contribution to your long-term care costs based on the value of your woodlot. The Department of Health's policy is that the value of a woodlot is its property tax assessment.

There are a number of ways to deal with this issue. For example, the property could be sold or harvested. Income taxes would have to be paid and the remaining cash would become part of your net assets. You could give this cash to your children, but under the Department's policy, gifts made within three years of application for assistance may be added back to your net assets. So you must do this well before you need long-term care.

You could give the woodlot to your children or establish a trust for them. Again, if you do this less than three years before your application, the amount of the property tax assessment could be added back to the net assets. The drawback here is that it probably will create an

immediate tax liability. So this approach will only work if cash is available to pay the tax. The tax payment would reduce net assets that would otherwise go to pay for long-term care anyway.

DONATING YOUR WOODLOT TO CHARITY

You may benefit a charity by donating your woodlot to it. Donation of land to a conservation authority is of particular interest to woodlot owners, but donations can be made to other charities as well. You could also donate a conservation easement to a conservation authority rather than the whole property.

A gift is a *disposition*. With one exception, which we will discuss later, the deemed (assumed) *proceeds of disposition* will be the *fair market value* of the property donated. This can result in a *capital gain*.

The deemed *proceeds of disposition* are treated as the amount of the charitable donation. The charitable donation earns a tax credit. The first $200 earns credit at the lowest tax rate, about 26 percent in Nova Scotia, and the rest earns credit at the top rate, about 48 percent.

The amount of donation that can be used for credit in any given year is equal to 75 percent of your net income plus 25 percent of any *taxable capital gain* that results from a charitable donation. This ensures that all of the *capital gain* will be eligible for credit in the year the donation is made. Any unused amount can be carried forward for five years.

Donating a woodlot to charity produces a tax saving since only 50 percent of the *capital gain* is taxed, and 100 percent of the value of the woodlot at the time of transfer earns credit as a donation. This can be a big advantage if you have unused *capital losses* that can shelter the *capital gain* from tax.

Example. Consider a taxpayer with a net income of at least $50,000 who donates a woodlot worth $40,000 to charity. Assume the woodlot cost $10,000.

Capital gain:

Proceeds of disposition	$40,000
Adjusted cost base	10,000
	30,000
Taxable capital gain: 50%	$15,000
Tax on gain (@ 39%)	$5,850

Tax credit for charitable donation:

On the first $200	$ 52
On the balance ($40,000 - $200) @48%	19,104
	$19,156
Tax saving	$13,306

Earlier we said there was an exception to the rule that the *proceeds of disposition* are the *fair market value*.

You can elect (choose) that the *proceeds of disposition* be any amount from the *adjusted cost base* of the property up to the *fair market value*. This is sometimes useful.

In the example above, the net income has increased to the point where Old Age Security payments—if the taxpayer is receiving them—would be clawed back. But that income could instead be just below the *clawback* level. Each taxpayer needs to examine his or her own situation.

A donation of a woodlot to a charity could be made during your lifetime or it could be made by way of bequest in your Will.

Exercise 7. Don Jacob donates 20 acres of land worth $10,000 to the Nova Scotia Nature Trust. The total 100 acre woodlot cost him $20,000 when he purchased it. Assuming the 20 acres donated was worth 1/5 of the purchase price when he bought it, what are the tax implications of the donation? Assume a marginal tax rate of 39%.

_____

_____

_____

_____

_____

_____

(answer is on page 68)

PROBATE FEES

In most cases, the *executor* will want to have the Will probated. That means he will ask the courts to allow the wishes in the Will to be fulfilled. This gives the *executor* a better legal status to deal with some aspects of the estate, and some confirmation that they have acted appropriately.

The schedule of fees payable to probate a Will in Nova Scotia is as follows:

Size of Estate	**Fee**
Less than $10,000	$70
$10,000 - $25,000	$150
$25,000 - $50,000	$250
$50,000 - $100,000	$700
More than $100,000	$700
for each additional $1,000	$12

Probate fees are based on the size of the estate, so if the estate size can be reduced, the fees will be reduced. There are several ways to do this.

As we noted earlier, life insurance can be made payable to your estate. This increases the estate, so it is more typical to name a specific person or persons as *beneficiary*.

Real property held in *joint tenancy* passes directly to the survivor without going through the estate. Spouses commonly hold the family home and some bank accounts jointly. Joint ownership may exclude an asset from the estate for probate purposes, but will not avoid income taxes if the asset really belongs to only one spouse.

Transferring assets to a trust will remove them from the estate. As we discussed earlier, this is quite complex and may not be suitable in most cases.

POWER OF ATTORNEY

Before your death, you may become mentally incapable of managing your affairs. Your family can get permission from a court to manage them, but this is a costly, time-consuming process. It is better to give someone a power of attorney. This is a document that gives them the right to manage your affairs, or certain aspects of them, if you become incapacitated. It requires legal advice, and should not be left too late.

ESTATE TAXES

Although there can be a significant tax liability on death because of *capital gains* caused by deemed *dispositions*, there are no estate taxes in Canada. Neither the estate nor its beneficiaries are liable for any tax based on the size of the estate alone.

LESSON THREE QUIZ

Based on your study of this lesson please circle the best answer.

1. Senior citizens who apply to the Dept. of Health for financial assistance for long-term care costs can ignore the value of their woodlots. T F

2. Donating a woodlot to a conservation authority is always considered by CCRA to be a gift and not a disposition. T F

3. When a will is properly prepared and an Executor has been appointed, probate fees are waived under Provincial Statutes. T F

4. Power of Attorney refers to the appointment of one person to carry out the affairs of another. T F

5. When property is held in joint tenancy among two people, title is immediately passed to the survivor at the time of death of the other. T F

6. In arriving at the value of a woodlot the provincial Department of Health will _____.
   A) consult recent real estate listings
   B) hire a forestry consultant
   C) use the property tax assessment

7. ___ percent of the value of a woodlot charitably donated may earn credit as a donation.
   A) 50% B) 75% C) 66% D) 100%

8. In assessing a senior citizen's eligibility for financial assistance for long term health care, the Nova Scotia Department of Health, among other things, will examine gifts made within _____ years to determine total net assets.
   A) 5 B) 6 C) 2 D) 3

9. Estate taxes in Canada are _____ levied.
   A) always B) sometimes C) never

(answers are on page 68)

CONCLUDING COMMENTS

In this home study module we have outlined and discussed income tax and estate planning issues relevant to Nova Scotia woodlot owners. As you can see, these issues are very complex, and it was necessary to present the information in a general way.

The income tax rules that deal with the mechanical calculation of income and tax are black and white. But issues such as business income versus *capital gains*, reasonable expectation of profit, the preferred business entity, and the availability of the "enhanced" *capital gains* deduction require interpretation and judgement.

Income tax considerations are an important part of conducting business in our present economic and regulatory environment. The annual filing of an income tax return is important—but proper income tax planning involves far more. There is often uncertainty and tough calls have to be made. Your professional advisor can assist with this process.

Each individual's situation is unique, and requires a specific estate plan. In complex situations professional help is advisable. As with any tax matter, circumstances change, so even the best of plans should be reviewed and updated on a regular basis.

GLOSSARY

Accrual Accounting: accounting method that includes accounts receivable in revenues accounts payable in expenses. the cost of *inventory* on hand at the end of a *fiscal year* is removed from expenses and reported as an asset.

Adjusted Cost Base: The cost of a capital property for income tax purposes. Most commonly, the actual purchase price of a property.

Alternative Minimum Tax: A refundable tax that is levied when a taxpayer has excessive tax shelters or preferences.Arm's Length: Having separate economic interests.

Attribution Rules: Complex rules in the Income Tax Act that are designed to prevent income splitting. That is, they prevent you from having your income taxed in another person's hands.

Beneficiary: A person who is entitled to receive income and/or capital from a trust.

Canadian controlled private corporation: A corporation that is not controlled by persons not resident in Canada, and whose shares are publicly traded.

Capital Cost Allowance: A way of deducting the cost of a capital item over time.

Capital Gain (Loss): The excess (or deficiency) of the proceeds of disposition of a capital property over its adjusted cost base and any costs of disposition.

Capital Property: Property which, if disposed of, would produce a capital gain or loss. Generally, property that is not inventory.

Cash Basis Accounting: accounting method where you only use revenues actually received and expenses actually paid in the year to determine income. The cost of *inventory* on hand at the end of the year is generally included in expense.

Clawback: A term used to mean the repayment of social benefits such as Employment Insurance and Old Age Security. This repayment occurs when a taxpayer's net income exceeds certain limits.

Commercial Woodlot: a woodlot operated by a taxpayer as a business with a reasonable expectation of profit

Crystallization: A transaction that triggers a capital gain, which can be sheltered

from tax by the capital gains exemption. Generally done with the shares of a corporation, it builds the capital gains deduction into the adjusted cost base of the property. This complex manoeuvre is best handled with professional tax advice.

Depreciable Property: Capital property, such as a building or equipment, which has a limited life. Depreciable property is written-off, for tax purposes, over a number of years.

Disposition: Disposing of property, either by selling or giving it away.

Estate Freeze: A transaction that creates two separate interests in an appreciating asset. One interest equals the current value of the asset but becomes a fixed amount. The second interest has little current value but will increase in value as the asset increases in value.

Executor: The legal representative of a deceased person. The person who manages the estate of a deceased person.

Fair Market Value: The value, in terms of money, that an asset would bring in an open and unrestricted market. The price for which something could be expected to sell.

Farm Property: Property used in the business of farming. Also includes an interest in a family farm partnership and shares of a family farm corporation.

Fiscal Year: A 12 month period over which annual accounts and taxes are calculated.

Intestate: Without a will.

Inventory: Property that is held for sale.

Joint Tenancy: A method of ownership where two or more persons each own an undivided interest in a property and have a right of survivorship. That is, on the death of one joint tenant, the property will pass to the other(s).

Mandatory Inventory Adjustment: When using the cash method of accounting, the cost of all items purchased for sale are deducted, even if they are unsold at the end of the year.

Marginal Tax Rate: The tax rate charged on the last dollar of income.

Matrimonial Property Act: A Nova Scotia statute that governs the distribution of matrimonial property if a marriage breaks down.

Median Rule: A method of calculating the adjusted cost base of a property owned on V-Day. The adjusted cost base is the middle amount among the cost, the V-Day value, and the proceeds of disposition.

Non-commercial woodlot - a woodlot not operated as a business with a reasonable expectation of profit.

Prescribed: specifically determined by the tax rules

Proceeds of Disposition: The value, for tax purposes, of consideration (payment) received for the disposition of a capital property. There are a number of provisions in the Income Tax Act that deem (or assume) proceeds to be a certain amount, typically either *fair market value* or the adjusted cost base.

Qualified Farm Property: Property used by a taxpayer or their family in the business of farming, as well as an interest in a family farm partnership or share of a family farm corporation. This kind of property must have been held for at least two years.

Qualified Small Business Corporation Shares: Shares of a small business corporation that have been held for at least two years.

Real Property: land and buildings, real estate.

Recaptured Depreciation: An amount included in income when too much depreciation has been deducted on a given class of property. This occurs when an asset is sold for more that the *undepreciated capital cost*.

Rollover: A transaction that, for tax purposes, is deemed to take place at the vendor's tax cost. Rollovers defer tax, but do not eliminate it.

Settlor: The person who creates a trust by transferring property to a trustee under the terms of a trust agreement.

Small Business Corporation: A Canadian controlled private corporation, all or substantially all of the assets of which are primarily used in an active business carried on in Canada.

Spouse Trust: A trust where, during the spouse's lifetime, only the spouse of the

deceased person may receive any income or capital from the trust.

Sundry Income: miscellaneous or "other" income, usually incidental to the main source of revenue.

Taxable Capital Gain: One-half of a capital gain acquired after October 18, 2000; two-thirds between February 27 and October 17, 2000; and three-quarters before February 27, 2000.

Terminal Loss: any remaining balance after all assets in a class have been disposed of.

Trustee: A person who holds property for another person.
Undepreciated Capital Cost: The remaining cost of depreciable property that has not yet been deducted.

Valuation Day (V-Day): December 31, 1971 (December 22, 1971 for publicly traded securities). The day before capital gains first became taxable in Canada. Capital gains accrued up until that date are not taxed.

APPENDIX 1: 2001 Nova Scotia Marginal Tax Rates[1]

Personal Taxable Income	Tax Rate (%)	Corporate Taxable Income	Tax Rate (%)[2]
On first $29,590	25.77	On first $200,000	18.12
On $29,590 to $30,754	30.95		
On $30,754 to $59,1803	36.95		
On $59,180 to $61,508	38.67		
On $61,508 to $79,530	42.67		
On $79,530 to $100,000	44.34		
On amounts over $100,000	47.34	On $200,000 to $300,000	27.12
		On excess over $300,000	45.12

1. Effective rates may vary somewhat depending on availability of the "supplementary personal credit" and the surtax reduction.
2. Rates are for active business income only and assume companies with less than $10 million in assets.

Cashbook Accounting Example

CASH RECEIPTS/BANK DEPOSITS

DATE	DESCRIPTION	BANK AMOUNT	SALES/ REVENUE	HST COLLECTED	MISC INCOME	LOANS RECEIVED	...	OTHER RECEIPTS	
Jan-12	LOGS TO XYZ LUMBER MILL LTD	8,050.00	7,000.00	1,050.00					
Jan-21	SOLD LOGGING TRUCK TO ABC CO.	12,937.50		1,687.50				11,250.00	
Jan-27	INCREASE IN BANK LOAN	5,000.00				5,000.00			
	MONTHLY TOTAL	25,987.50	7,000.00	2,737.50	0.00	5,000.00		11,250.00	

CASH DISBURSEMENTS/BANK WITHDRAWALS

DATE	DESCRIPTION	CHQ #	BANK AMOUNT	HST PAID	WAGES & BENEFITS	REPAIRS & MAINT	INTEREST EXPENSE	PHONE	LOAN PAYMENTS	OTHER
Jan-04	BANK LOAN PAYMENT		2,500.00						2,500.00	
Jan-10	DEF GARAGE - TRUCK REPAIRS	1001	831.39	117.36		782.39				
Jan-14	EMPLOYEE WAGES	1002	826.00		826.00					
Jan-15	RECEIVER GENERAL - RE DECEMBE	1003	415.00		415.00					
Jan-20	MT&T	1004	106.52	13.89				92.63		
Jan-27	GHI LTD - NEW LOGGING TRUCK	1005	32,100.00	4,500.00						30,000.00
Jan-28	EMPLOYEE WAGES	1006	826.00		826.00					
Jan-31	BANK INTEREST		322.46				322.46			
	MONTHLY TOTAL		37,927.37	4,631.25	2,067.00	782.39	322.46	92.63	2,500.00	30,000.00

APPENDIX 3: END NOTES REFERRED TO IN TEXT, TAX GUIDES, INTERPRETATION BULLETINS AND FORMS

End Notes

1. Interpretation Bulleton IT-373R2, Woodlots, paragraph 11
2. Income Tax Act, paragraph 19(1)(a)
3. Income Tax Act, subsection 248(1)
4. Interpretation Bulletin IT-373R2, paragraph 14
5. Interpretation Bulletin IT-373R2, paragraph 26
6. Income Tax Act, section 127.5
7. Income Tax Act, paragraph 12(1)(x)
8. Income Tax Act, subsections 13(7.4) and 12(2.2)

The CCRA publishes "Tax Guides" and "Interpretation Bulletins" to provide information to assist taxpayers with tax compliance requirements as well as document their position with respect to technical matters. A sample of publications that may be of interest to woodlot owners follows:

Tax Guides

2001 General Tax Guide
2001 Business and Professional Income Tax Guide
2001 Pension and RRSP Tax Guide
2001 Farming Income Tax Guide
2001 Employers Guide to Payroll Deductions
2001 Employers Guide to Payroll Deductions - Taxable Benefits
2001 T5 Guide - Return of Investment Income
2001 T2 Corporation Income Tax Guide
2001 Corporation Instalment Guide

Interpretation Bulletins

IT-79R3 Capital cost allowance - Buildings or other structures
IT-128R Capital cost allowance - Depreciable property
IT-138R Computation and flow through of partnership income
IT-218R Profit, capital gains and losses from the sale of real estate, including farmland and inherited land and conversion of real estate from capital property to inventory and vice versa
IT-220R2 Capital cost allowance - Proceeds of disposition of depreciable property
IT-232R3 Losses B Their deductibility in the loss year or in other years
IT-234 Income of deceased persons - Farm crops
IT-268R4 Inter-vivos transfer of farm property to a child
IT-285R2 Capital cost allowance - General comments

IT-287R	Sale of inventory
IT-322R	Farm losses
IT-349R3	Intergenerational transfers of farm property on death
IT-373R2	Woodlots
IT-425	Miscellaneous farm income
IT-433R	Farming or fishing - Use of cash method
IT-478R	Capital cost allowance - Recapture or terminal loss
IT-485	Cost of cleaning or levelling land
IT-501	Capital cost allowance - Logging assets
IT-526	Farming - Cash method inventory adjustments

FORMS

Forms that would be commonly filed by a woodlot owner carrying on business as a proprietor or partner are:

T1 General	Federal and New Brunswick Individual Income Tax Return
Schedule 1	Detailed Tax Calculation
Schedule 2	Amounts Transferred From Your Spouse
Schedule 3	Capital Gains or Losses
Schedule 4	Statement of Investment Income
T2124	Statement of Business Income and Expenses
T2038	Investment Tax Credit - Individuals
T2042	Statement of Farming Income
CCA	Summary of Capital Cost Allowance

Forms that would be commonly filed by corporations (in addition to financial statements for the business) include:

T2	Corporation Income Tax Return
S1	Reconciliation of Net Income Per Financial Statements With Net Income For Federal Income Tax Purposes
S2	Charitable Donations
S4	Continuity of Losses Carried Forward
S8	Summary of Capital Cost Allowance
S31	Investment Tax Credit - Corporation

In addition, **employers** would be required to file:

T4 Summary	Summary of Remuneration Paid
T4 Supplementary	Statement of Remuneration Paid.

APPENDIX 4: EXERCISE AND QUIZ ANSWERS

Part 1: Income Tax Guide

Exercise 1. This should be claimed as income since the payment will be based on volume and it is occurring frequently.

Exercise 2. Yes, since he has a management plan and is planting, thinning, etc. instead of just harvesting

Exercise 3. $3000

Exercise 4.

Part A) deduction for ATV would be 5600 x 30% x ½ (first year) = $840
deduction for sulky would be $500 x 20% x ½ = $50
Total = $890

Part B) depletion allowance = cords harvested/cords documented by cruise x (woodlot cost - bare land value)
= 20/2000 x ($32000 - $15000) = 0.01 x $17000 = $170

Exercise 5.

Capital Cost Allowance: 30,000 x 30% x 0.5 (year of purchase) =	$4500
Marginal tax rate	x 25%
Tax reduction	$1125
Investment tax credit $30,000 x 10%	$3000
Total tax reduction	$4125

Quiz 1: T, T, F, T, F, F, F, T, A

Quiz 2: F, F, T, T, T, F, T, F, F, C

Quiz 3: F, T, F, T, T, T, T, T, A, woodlot, barn, and tractor chains

Quiz 4: T, F, F, T, F, T, T, T, T, B, A

Part 2: Estate Planning Guide

Exercise 6. A)When you die scenario: child's cost of the property would be deemed to be $10,000 (This assumes the woodlot meets the criteria for qualified farm property, otherwise it would be deemed to be disposed of at fair market value at the time of death).

Give it to her now scenario: Deemed proceeds of disposition would be $10,000 (again, assumes qualified farm property). There would be no gain or loss and a cost of $10000 for her daughter.

Answer is no difference.

B) yes, in this case it would be better for Mrs. White to sell the woodlot to her at a price between $10,000 and $20000. A selling price of $20,000 would result in a capital gain as follows:

($20,000 - $10,000) x 1/2 = $5000. Thus, this would be offset by her capital loss. The cost of the property to the daughter would be $20,000, reducing her taxes when she disposes of the property in the future.

Exercise 7.

Proceeds of disposition.	$10,000
Adjusted cost base	$4000
Capital gain	$6000
Taxable capital gain (50%)	$3000
Tax on gain (at 39%)	$1170

Tax credit for charitable donation:	
on the first $200	$ 52
on the balance ($10,000 - $200) at 48%	$4704
	$4756
Tax savings ($4756 - $1170)	$3586

Quiz 1: T, F, T, F, FMV - original cost

Quiz 2: F, F, B, C, T, B & C from A, T, T, F, F, T, F

Quiz 3: F, F, F, T, T, C, D, D, C